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Memorandum for:

Attached is our first set of background papers on country positions for the Venice Economic Summit. They were requested by Mr. Steven Danzansky, Senior Director for International Economic Affairs, NSC, and were delivered to him, Mr. Allen Wallis at State, and Mr. Fauver at Treasury on 15 December 1986.

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E U R A

**Office of European Analysis
Directorate of Intelligence**

Central Intelligence Agency



Washington, D. C. 20505

Venice Summit

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VENICE SUMMIT: COUNTRY POSITIONS

12 DECEMBER 1986

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This typescript was produced by analysts in the Office of European Analysis and Office of East Asian Analysis. Questions and comments can be directed to

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Chief, Western Europe Division

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JapanPolitical and Economic Setting

Prime Minister Nakasone will be seeking a share of the limelight at the Venice Summit to keep open the possibility of a second extension of his tenure in office, now scheduled to end in October 1987. Nakasone has continued to keep his political leverage intact during his final years in office by maintaining unusually high popularity ratings and playing his would-be successors off against one another. We do not believe Nakasone is at risk from an effort to unseat him before the Summit, although his rivals could attempt to blame him in the unlikely event his party loses badly in local elections this April. [redacted]

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By the time Nakasone arrives in Venice, the already sluggish Japanese economy will probably have weakened further. The 50-percent appreciation of the Japanese yen against the US dollar since the summer of 1985 has cut export volumes, squeezed profits, and forced firms to reduce investment spending. Our econometric model of the Japanese economy [redacted]

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[redacted] suggests an acceleration of these trends in the months ahead, with export volumes dropping at least through the summer of 1987 before a recovery begins later that year. Overall, we expect real GNP to grow only 2 percent this year, with only a slight improvement in 1987. [redacted]

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Macroeconomic Policy Coordination Tokyo continues to view international coordination of macroeconomic policies as a mixed blessing. The Japanese have lobbied strongly in recent months for G-5 and bilateral action to stabilize the yen/dollar exchange rate and have participated, albeit reluctantly, in coordinated discount rate cuts. On the other hand, the government shows little sign of bowing to growing domestic and international pressure for a major economic stimulus program to revive the lagging economy. [redacted]

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Structural Adjustment Nakasone has generated little support for structural adjustment in spite of his pre-Tokyo Summit endorsement of proposals to reduce the Japanese economy's dependence on exports. He will be able to point to an increasing number of Japanese companies choosing to locate manufacturing plants overseas--a process accelerated by the strong yen. He will probably be in a position to cite a wide-ranging reform of the tax code, but we suspect the stimulus to consumer spending provided by income tax cuts will be nullified by consumption tax increases. Other measures to expand domestic spending have little prospect of being implemented soon. New legislation being pushed by the Ministry of International Trade and Industry to restructure depressed industries such as textiles and steel may in the final analysis make the remaining Japanese

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producers more internationally competitive rather than fostering a shift to domestic markets. [redacted]

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Agricultural Reform Nakasone put himself ahead of the government bureaucracy and the ruling party when he agreed at the Tokyo Summit "to redirect policies and adjust the structure of agricultural production in the light of world demand." Agriculture Ministry objections have impeded Japanese agreement to discuss domestic subsidies for farmers in the GATT forum. The ministry is unwilling to move on reform until the European Community agrees to discuss its Common Agricultural Policy. The hurdles make it unlikely, in our view, that Nakasone will be in a position to make any further commitments in Venice. [redacted]

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Third World Debt The Japanese government has pledged to support the US debt initiative which Finance Minister Miyazawa publicly endorsed at the IMF/World Bank annual meetings in September. In addition, Japanese banks appear to be taking a more activist role in debt negotiations and can no longer be counted on to accept the judgment of large US and West European banks during rescheduling negotiations. [redacted]

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International Monetary Reform Japanese officials are lobbying for an increase in Japan's voting strength in the World Bank, hoping that it will be a precedent to help Japan secure a larger voting share in the IMF when Fund replenishment is considered in 1988. Tokyo would undoubtedly continue to oppose international monetary reforms that would fix or establish target zones for exchange rates. Both Finance Minister Miyazawa and Bank of Japan Governor Sumita have emphasized publicly that the recent US-Japan agreement to stabilize exchange rates does not include a target zone for the yen-dollar rate. [redacted]

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International Trade Tokyo, in our view, sees no compelling internal or external reasons for major trade policy initiatives in the months leading up to the Venice Summit. Officials are optimistic that the 50-percent appreciation of the yen relative to the dollar over the past 15 months will soon trim Japan's trade surplus and ease trade tensions. Nonetheless, we project that both the trade and current account surpluses will almost certainly top \$75 billion in 1987. [redacted]

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Political Issues

Terrorism Japan's position on international terrorism has not changed since the Tokyo Summit, and we believe Tokyo can be expected to continue its "follower" role on this issue. The Japanese would probably prefer that discussions on this topic in Venice be limited, particularly because Nakasone was criticized domestically for "caving in" to US and British pressure to name Libya as a source of terrorist activity in 1986, and

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because of the increasing domestic sensitivity to Washington's handling of anti-terrorist matters. [REDACTED]

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Arms Control Japanese attention to this issue has grown since the last Summit. Prime Minister Nakasone, in particular, continues to support US arms control policies and will be an effective advocate for Western interests if Soviet General Secretary Gorbachev visits Japan. According to US Embassy reporting, Tokyo was pleased that at Reykjavik the United States was able for the first time to convince the Soviets to address SS-20 reductions in the Soviet Far East. The Japanese, in our view, will continue pressing Washington and European capitals to give due consideration to Asian security concerns. Ultimately, Tokyo may seek more explicit acknowledgement of Asian security interests in Summit documents.

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West GermanyPolitical and Economic Setting

Chancellor Kohl's government is currently preoccupied with the 25 January federal election. Polls give the current coalition a wide lead over its opposition, with one poll suggesting that the CDU/CSU could win an outright majority. The coalition is stressing its strong economic performance and loyalty to NATO. Most ministers are expected to remain in their current positions, including Foreign Minister Genscher and Finance Minister Stoltenberg. Bonn is also currently concerned with a recent cooling of West German-Soviet relations and the ramifications of the recent court finding of Syrian involvement in a terrorist act in Berlin.

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The West German economy is expected to grow by 2.5 percent in 1986, with private consumption replacing trade as the driving force behind expansion. Growth prospects for next year are in the 2-3 percent range. Unemployment has dropped steadily this year, but remains stubbornly above the politically sensitive 2 million level, and will remain so according to most forecasters. Largely due to government efforts to slow the decline of the US dollar, monetary growth has overshoot its target for the first time since ranges were established in 1979. Bundesbank officials have used this to argue against Washington's call for a further easing of monetary policy. In addition, Bonn also claims that because import volumes are growing much faster than export volumes, West Germany is already making a contribution to world economic adjustment.

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Economic Issues

Macroeconomic Policy Coordination West Germany has been a strong supporter of policy coordination in principle, although the government firmly rejects a locomotive role for itself. Finance Ministry officials viewed the commitment to seek non-inflationary growth through macroeconomic policy convergence as a key achievement at the Tokyo Summit, and both Finance Minister Stoltenberg and Bundesbank President Poehl stressed Bonn's continued support for consultation at the recent IMF meetings. Despite its enthusiasm for policy convergence, Bonn strongly resists the use of macroeconomic indicators as triggers for automatic policy responses.

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Structural Adjustment Over the past few years Bonn has reduced government regulation of the economy and removed distortions in the tax system that have hindered economic growth. Bonn can also point to the modest results it has achieved by relaxing rules governing the labor market and lowering marginal tax rates. Steps to further liberalise West German financial markets are being undertaken and the government plans to enact tax reform worth \$20-25 billion within the next few years. Bonn continues to subsidize a number of sectors, however, including coal, steel, agriculture, and shipping, and subsidy levels have actually risen under Kohl. The government does not intend to cut these subsidies in the tax reform package.

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[redacted]

Agricultural Reform Due to the structural problems affecting agriculture, Bonn will probably offer only half-hearted support for agricultural reform. The government will probably voice its support for the agreements reached at Punta del Este, which it believes provide a good basis for negotiation. Bonn rules out, however, the complete elimination of export subsidies--which it sees as the glue that holds the CAP together

[redacted]

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Third World Debt Despite public avowals of support for the US debt initiative Bonn has doubts about its ability to solve the problem of Third World debt.

[redacted]

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[redacted] Bonn continues to believe the debt problem is best handled on a case-by-case basis and considers it important that the World Bank and others have adequate resources for this task. Bonn has recently expressed its support for an \$11.5 billion IDA replenishment and for increasing the World Bank's capital. [redacted]

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International Monetary Reform Bonn adamantly opposes anything beyond minor tinkering with the current global monetary system and is virtually certain to maintain this stance in Venice. In particular, Finance Minister Stoltenberg and Bundesbank President Poehl firmly oppose the concept of target zones for exchange rates. Their opposition stems from their belief that because trade accounts for a relatively small proportion of US GNP, Washington would ultimately be unwilling to subordinate its economic and financial policies to maintain the exchange rate zones. As a result, West Germany would have to bear a greater responsibility for intervention than was economically warranted, damaging Bundesbank efforts to control domestic monetary growth. Bonn may attempt, however, to secure a US commitment to intervene in defense of the dollar at some specified level. [redacted]

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International Trade Bonn will support work underway in the new GATT round and will press the US to resist the implementation of protectionist measures. They will also push Japan to more rapidly open its domestic markets to foreign goods. [redacted]

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Political Issues

Terrorism Bonn will probably continue to oppose the use of economic sanctions--which it believes are ineffectual and unenforceable--and the breaking of diplomatic relations with countries sponsoring terrorism. Because of its experience with indigenous and Mideast-sponsored terrorism, Bonn does support closer cooperation among Summit countries, increased counterterrorist measures, the reduction of diplomatic contacts, and increased surveillance. [redacted]

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Arms Control Bonn will strongly support the maintenance of existing arms agreements, such as SALT II and ABM, and the continuance of the arms control dialogue. Bonn is also likely to press for more frequent consultations on arms control issues, in part to ensure that European security interests are taken into account, but also to remedy what it perceived as the lack of either a long term strategy or comprehensive goals evident in the proposals discussed at Reykjavik. Bonn is likely to press its view that tradeoffs covering the entire arms field--conventional, chemical, and nuclear--should be discussed and analyzed before negotiations begin on eliminating any particular component. The West Germans believe that interim agreements or partial reductions are more realistic short-term goals than the wholesale elimination of parts of the West's nuclear arsenal. [REDACTED]

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FrancePolitical and Economic Setting

Despite tensions between Socialist President Mitterrand and conservative Prime Minister Chirac over political philosophy and personal prerogatives, neither is willing to risk a public opinion backlash by sabotaging their uneasy "cohabitation" before the scheduled presidential election in 1988. Chirac now appears to have gained the upper hand in foreign policy decision making, although he cannot completely ignore Mitterrand. The conservatives' razor-thin majority in the National Assembly has enabled them to pass most of the major legislation promised in their electoral platform. The public unity forged by the terrorist campaign in Paris during September and the resulting success of both leaders in public opinion polls have dissipated. Moreover, Chirac's mishandling of the education issue and student demonstrations has been a major setback for his government. The major question now is who besides Chirac will run for President--and how successfully. []

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Helped by lower energy prices and the falling US dollar, the French economy is performing relatively well. Real GDP should increase about 2.3 percent this year, after growing 1.3 percent in 1985. Inflation is at its lowest in twenty years, with price rises averaging about 2.3 percent compared to a 5.8-percent increase last year. The French balance of payments is also showing its best performance since 1979. The trade balance is expected to improve significantly and the almost \$1.0-billion current account surplus France had last year is expected to grow to around \$4.0 billion in 1986. The dark cloud in the French economic picture is unemployment, which reached a post-war high of 10.7 percent this fall and is unlikely to improve next year. []

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Economic Issues

Macroeconomic Policy Coordination The French government is very interested in enhancing policy coordination among industrialized countries. Finance Minister Balladur announced in late November that he would shortly submit to other EC members his ideas on how to reinforce economic and monetary policy coordination with the US and Japan. Balladur has already given the US Treasury some of his ideas on the selection of these particular economic indicators that would trigger consultations, including exchange rates, interest rates, and current account balances. []

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Structural Adjustment France has undertaken considerable deregulation of its capital and foreign exchange markets. In a significant departure from the past, the French are planning to shift to open market operations and reserve requirement management to control interest rates and the money supply and to eliminate quantitative credit limits. They also plan to privatize a substantial number of government-owned enterprises, especially banks, although the ultimate extent of these sales depends on the result of the next national elections. []

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Agricultural Reform France will continue to maintain its hardline stance against agricultural reform. [REDACTED]

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Third World Debt The French are still concerned about the LDC debt problem and some French officials see a shift in emphasis from Latin America to Africa and the Middle East, with particular concern about Egypt. They also see the main burden shifting from government/bank coordination to one that falls mostly on governments. Bank of France Governor Camdessus has proposed a special IMF facility for sub-Saharan Africa. [REDACTED]

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International Monetary Reform France is primarily interested in promoting exchange rate stability and maintaining the EMS. On policy coordination, [REDACTED] the G-5 should be the key group and that the US-Japan "group of two" poses a problem of face for the French. Paris also perceives a change in the US attitude toward coordination of exchange rate policies. Balladur will continue to propose the adoption of exchange rate target zones, which he tentatively envisions as having wide (6-10 percent) ranges and not requiring automatic central bank intervention. [REDACTED]

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International Trade Paris was pleased with the outcome of the Punta del Este meetings and thinks that the understandings worked out there are a good basis for future trade rounds. Since the French were disappointed that Japan was not pressed harder on opening up its markets and stimulating growth, they will continue to press these issues at the Summit. [REDACTED]

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Political Issues

Terrorism Paris follows a two-pronged approach to terrorism, tightening security at home while negotiating internationally to prevent terrorist attacks on French soil. Chirac has continued a longstanding French policy of using emissaries to deal with terrorist groups and their state sponsors. His immediate motive is to obtain the release of French hostages held in Lebanon, and to this end, he has decided to normalize relations with Iran and improve relations with Syria. Beyond the hostage question, however, Chirac shares the traditional French view that France's influence in the Middle East must be upheld, and that this cannot be done through sanctions and public denunciations. After years of foot dragging, France may now be willing to accept a strong denunciation of terrorism in the Summit communique, as long as it is not too specific. [REDACTED]

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Arms Control The French, who believe that nuclear deterrence is the only credible defense policy, oppose the wide-ranging arms control proposals introduced at Reykjavik. Paris is critical of the proposals for a ballistic missile free world and the zero INF option in Europe because these could undermine French defense consensus, increase pressure to reduce French nuclear forces, and leave Europe vulnerable to Soviet superiority in conventional and chemical weapons. Paris also objects strongly to holding conventional arms control negotiations in an alliance-to-alliance forum outside the CSCE. [REDACTED]

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United KingdomPolitical and Economic Setting

The United Kingdom is now in a pre-election period with widespread speculation that Prime Minister Thatcher will call an election this coming spring. After trailing the Labor Party for a year, the Conservatives have recaptured the lead in several recent opinion polls. Thatcher probably will spend the next few months citing the recent substantial increase in spending on education and health services as evidence that her "uncaring image"--which party strategists believe is a major handicap for the Tories--is undeserved. Thatcher will also try to turn the public's gaze from her economic policies by making defense a major campaign issue, lashing out especially at the Labor Party's policy of unilateral nuclear disarmament, which polls show to be unpopular with most Britons. []

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Additional government spending also comes at a critical time since the five-year old British recovery appears to be losing steam, with real GDP growth limited to between 2 and 2.5 percent in 1986. The government's most recent forecast anticipates 3 percent growth in 1987, a figure we consider overly optimistic given continued slow growth of Britain's major trading partners and high UK interest rates. Consumption spending has provided one major stimulus to growth in 1986 as a result of a sharp rise in real earnings--due to high wage settlements and an inflation rate below 3 percent. Inflation, however, has begun to pick up again and will approach 4 percent in 1987. Private investment has been sluggish due to high real interest rates and depressed activity in the oil sector. Developments in foreign trade have also been unfavorable with a sharp rise in imports--due to the surge in consumer spending--and poor export performance--due to a sharp drop in oil exports and a flat performance by non-oil exports. This has led to a trade deficit of \$8.7 billion for the first ten months of 1986. The current account is likely to be in small surplus for the year, but forecasters predict a deficit in 1987, the first since Thatcher came to power in 1979. []

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The Thatcher government's major economic liability continues to be unemployment, which will remain an important election issue. The government redefined its definition of unemployment in June which lowered the rate from 13.3 to 11.7 percent. Since that rate has now fallen to 11.5 percent, the government is heralding a reversal in the jobless trend. []

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Economic Issues

Macroeconomic Policy Coordination London continues to believe that industrial countries should coordinate their fiscal and monetary policies to stabilize the world economy, but does not want a system which would impede its autonomy on policy. Thatcher is not likely to push West Germany, but would welcome reflationary policies by Bonn that would also spur British growth. []

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Agricultural Reform The overriding objective of London's EC policy continues to be the adoption of more realistic Community agricultural policies to lower production and reduce support prices. London is not satisfied with progress made on agricultural reform and will continue to raise the issue in EC forums. The British view their Agricultural Minister's proposal to set aside excess cereal land as a way to stimulate discussion on reducing cereal surpluses. []

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International Monetary Reform British officials continue to be concerned by weakness in the pound--especially against the deutsche mark--which forced London to raise interest rates in October. Chancellor of the Exchequer Lawson said he believes that some depreciation was necessary, but that London would resist any further fall in sterling's value. London is not in favor of exchange rate target zones which would limit its flexibility in formulating independent policies. As such, Thatcher remains opposed to making Britain a full member of The European Monetary System. []

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International Trade The British remain concerned about protectionist sentiment in the US Congress. Officials have expressed dismay over legislation passed at the end of the last congressional session--including the superfund and customs users fees--and believe more protectionist measures are inevitable. []

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British officials were pleased with the Punta del Este meeting that launched the new trade round, and consider it a major success. London continues to believe that Japan must take more action to deal with its trade surplus. British Trade Minister Channon recently told [] that Britain and Japan's other trade partners are still looking for real signs that Japan is moving its economy away from export-led to domestic-led growth. He also said that the US and Japan share primary responsibility for the continued good health of world trade. []

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Political Issues

Terrorism Publicity about US arms sales to Iran may make the British more wary about using the Summit for high visibility comment on combatting terrorism. British officials have reiterated publicly the need for counterterrorist cooperation but remain opposed to economic sanctions against states accused of supporting terrorism. The Hindawi/El Al trial forced the Thatcher government to break diplomatic relations with Damascus. The diplomatic rupture has not yet significantly affected bilateral trade relations although Damascus unilaterally abrogated a UK-Syrian aviation agreement. []

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Arms Control British officials have been skeptical of the sweeping nuclear reductions discussions at Reykjavik. London has reluctantly endorsed a zero INF in Europe agreement and a 50 percent cut in strategic nuclear arsenals, but is opposed to the complete elimination of ballistic

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missiles over a ten-year period, partly for fear that it would endanger its Trident submarine program. The UK has maintained that any far-reaching arms control agreement needs to be preceded by accords on shorter-range nuclear forces and chemical weapons. London favors an agreement on conventional weapons and has argued that new negotiations on conventional forces should be loosely tied to CSCE to encourage French participation.

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Other Political Issues The British may raise the issue of South Africa and argue for "positive sanctions"--such as aid to poor blacks in South Africa and neighboring countries--rather than punitive economic measures. Efforts to find an agreed Summit position would be designed to lesson charges that London is isolated on South Africa. Thatcher may also stress the need for encouraging Jordanian economic efforts on the West Bank to restart the Middle East peace process.

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ItalyPolitical and Economic Setting

Italy's political leaders will focus their attention over the next few months on the planned transfer of the Prime Ministry from the Socialists to the Christian Democrats. Under an agreement reached by the governing five-party coalition last summer, Socialist Prime Minister Craxi will step down in March 1987 and be replaced by a Christian Democrat, probably Foreign Minister Andreotti. Although the prospects for a reasonably smooth transfer of power look fairly good, coalition-tensions are again on the rise and the accord could still unravel. This would probably force early elections next spring, but these would be unlikely to produce marked shifts in the major parties' voting shares. It is thus likely that the current five-party coalition will still be in power in June 1987, although probably headed by a Christian Democrat. Meanwhile, the uncertainties connected with the planned change in leadership have reportedly deflected attention away from the Summit

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Whoever is Prime Minister next June will enjoy a generally more favorable economic situation than most of his recent predecessors. Italian GDP is expected to expand about 2.8 percent this year and 3.2 percent in 1987. Company profits will have soared by some 35 percent during 1986 following a similar advance the previous year. Inflation has been cut in half over the past three years from over ten percent to about five in 1986. Unemployment should rise slightly in 1987 to just over 11 percent, but the effects of unemployment continue to be offset by employment in the burgeoning underground economy.

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Italy's balance of payments and public sector deficits will remain major problem areas. After surging temporarily into surplus in 1986, the current account seems certain to run a deficit next year. The public sector deficit should remain at about 15 percent of GNP, but Rome could face greater difficulties in financing it. Government securities may become less attractive investments due to the rapid development of alternative domestic investment opportunities, the recent loosening of capital controls, and the imposition of a capital gains tax on newly purchased government securities.

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Economic Issues

Macroeconomic Policy Coordination Italy is likely to resume its push for greater coordination of macroeconomic policies. The Italians support efforts to persuade other West European countries, particularly West Germany, to be more expansionist. The Italians will nonetheless be restrained in expressing their concerns about the economic policies of other Summit countries--especially the large US budget deficit--because Rome is vulnerable to criticism about its own massive budget deficit.

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Structural Adjustments Rome will strongly endorse continued progress toward structural reform and can point to several of its own domestic initiatives. Italy recently eased exchange controls and modified the controversial scala mobile (wage indexation system). These reforms will increase Italian competitiveness in international markets and promote exchange rate stability, which will help declining export sales. In addition, Rome's progress toward greater liberalization of capital markets--through the creation of new financial instruments--has enhanced capital formation and improved company profitability. []

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Agricultural Reform Italy's agricultural policy is bound to the EC's Common Agricultural Policy and this makes it unlikely that Rome will take an outspoken, independent stance on agricultural issues at the Summit. Nevertheless, as a net importer of foodstuffs, Italy clearly has an interest in any proposals that would result either in a lower food import bill or in reduced EC farm subsidies. Rome may thus be somewhat more receptive than Paris or Bonn to US proposals for modifying the CAP -- so long, of course, as the interests of Italian farmers are not threatened. []

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Third World Debt Italy has been sympathetic to Third World interests on the debt issue in international meetings and Rome is likely to take the opportunity as host country to put forward a proposal on the debt problem. This will probably include measures that Italy has favored at other Summit meetings, such as closer collaboration between the IMF and the World Bank, and a capital increase for the World Bank. In addition, Italian leaders may adopt the position of the Bank of Italy by supporting in principle the US debt initiative to deal with LDC debt. []

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International Monetary Reform Rome takes seriously its participation in the newly formed G-7 and is disturbed about the continuing strong influence of the G-5. Rome now also fears that both the G-7 and G-5 have been undercut by a newly formed "G-2" of Washington and Tokyo. Italy will press for assurances that it will be included in any future discussion on monetary policy coordination. In addition, Italy may press for the creation of a more stable monetary system modeled on proposals discussed at Tokyo. Such a system, as the Italians see it, would designate exchange rate target zones based on a dollar-yen-ECU alignment. []

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International Trade Trade policy will be of great concern to Rome in 1987 and the government remains very worried about growing pressures for increased barriers to trade -- especially in the US. It may use the Summit as a forum to argue against growing protectionism and to step up earlier criticism of restrictive Japanese trade policies. []

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Political Issues

Terrorism The Italian political leadership has been divided on counterterrorism policy between those, such as Defense Minister Spadolini, who favor a fairly tough line against states sponsoring terrorism and

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others, such as Foreign Minister Andreotti, who prefer to conciliate these states. Hardline views have generally prevailed since the last Summit, but Spadolini and his supporters believe that their position has been gravely undercut by the revelations about US arms sales to Iran. Andreotti and his supporters will probably increasingly call the tune on counterterrorism policy, especially, if Andreotti accedes to the Prime Ministership. We therefore doubt that Italians will favor any toughening of the Tokyo Summit's Terrorism Declaration to include an explicit policy of applying sanctions against states sponsoring terrorism. Rome would probably be receptive, however, to an agreement promoting international technical cooperation against terrorism, especially one that would legitimize its recently announced policy of x-raying diplomatic pouches. [REDACTED]

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Arms Control Rome has been publicly supportive of recent US arms control positions and has tended to identify Moscow's intransigence on SDI as the stumbling block to an agreement. At the same time, Foreign Minister Andreotti has privately probed US diplomats about possibilities for a compromise on SDI research. The Foreign Ministry has also privately told US diplomats that it worries about the "zero option" for INF deployments because it believes this would leave Western Europe vulnerable to Soviet pressures, and Rome has publicly called for US adherence to the Salt II limits. Thus, while Rome would probably be willing to go along with a general statement endorsing US proposals, it will privately urge flexibility and caution. [REDACTED]

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CanadaPolitical and Economic Setting

Prime Minister Mulroney's Conservative government has lost much of its initial popularity --in public opinion surveys it trails the Liberals by 15 percentage points and has only a slim lead over the New Democrats. After reorganizing his cabinet in June and adjusting his legislative priorities, Mulroney hoped to build momentum when the second parliamentary session opened in October, but his program was poorly received. Even the Tories' centerpieces--legislation deregulating the energy sector and reforming the tax and financial systems--failed to evoke much enthusiasm.

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The Canadian economy is expected to grow by less than 3 percent this year, down from 4.0 percent in 1985. The slowdown is due to declining domestic investment following the collapse of oil prices and a drop in exports to the US. Canada's current account deficit will deteriorate from \$1.9 billion in 1985 to \$6 billion in 1986 due to the sluggishness of exports and an increase in debt service caused by a steep rise in net foreign investment. Premium interest rates offered on domestic financial assets over comparable US instruments have stabilized the Canadian dollar, but the higher rates will impede fixed business investment and slow employment growth. The unemployment rate, at a four-year low of 9.4 percent for October, could rise to 10 percent by year-end.

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Economic Issues

Macroeconomic Policy Coordination While supportive of efforts to coordinate economic policies that will spur economic growth, policy coordination is not a primary issue with the Canadians. Ottawa has yet to clarify its views on the use of indicators, other than being generally supportive of their value in monitoring policy. Canada does expect to be included in all economic and monetary decisions, unless reserved specifically for the G-5. Ottawa is unlikely to call attention to the international effects of US budget deficits since it has large deficits of its own.

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Structural Adjustment The government has achieved mixed results in making structural adjustments to the economy. Ottawa will propose tax reforms in early 1987, probably emphasizing a broad-based value-added tax and revisions to personal and corporate rates that bring Canada more in line with US reforms. Late this year, the government will also move to reform and integrate the financial services sector. While these efforts will undoubtedly encourage domestic investment, Ottawa does not plan

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measures to significantly reduce barriers to foreign investment since it wants to maintain Canadian control of key industries. [REDACTED]

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Agricultural Reform Agriculture will continue to be the major focus of the Canadians as it was at the GATT talks in Uruguay. Canada is concerned by what it sees as a growing grain war between the US and the EC, and the negative effects of this war on Canada's traditional export markets. [REDACTED]

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Third World Debt Ottawa continues to support the US debt initiative. Speaking at the IMF/World Bank annual meetings, Finance Minister Wilson cited the constraints on developing nations' economic growth caused by high external debt and weak export markets. He noted that inadequate financial inflows to these countries are occurring at a time when capital infusions are needed to spur their economies. Wilson called for an expansion of IMF borrowing limits and an IDA replenishment of at least US \$12 billion, while citing the need for recipient countries to make structural adjustments and to pursue appropriate macroeconomic policies. [REDACTED]

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International Monetary Reform Canadian officials are sensitive to the impact of domestic monetary policy on exchange rates and are continuing efforts to stabilize the Canadian dollar. These efforts have been especially important to Ottawa due to the freer-trade talks with the US, but the idea of target zones for exchange rates, particularly in a bilateral context, has received little support. [REDACTED]

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International Trade Canadian officials were elated with the inclusion of agriculture in the coming GATT round partly because the new round offers another way to improve its trading relationship with the US. The centerpiece of Canada's concerns about international trade is the proposed freer-trade agreement with the US. A recent poll shows that 42 percent of the Canadian public supports the initiative, but trade disputes continue to raise fears about US protectionism. Ottawa will continue to stress that its negotiations with the US will not lessen its commitment to multilateral trade talks. Indeed, the Canadians support expanding the powers of GATT to include a mechanism for settling trade disputes. Ottawa would be unwilling to sacrifice its immediate goal of a bilateral agreement with the US for longer-term benefits under the GATT or other multilateral forums. [REDACTED]

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Environment Ottawa is extremely concerned about cross-border pollution from the US and will undoubtedly press for statements on the need for greater international cooperation on environmental issues. Canadians are particularly sensitive about acid rain and are likely to join forces with concerned Europeans on this issue. Close consultation with Washington on pollution has produced Canadian positions on toxic waste and ozone depletion in line with US policy. [REDACTED]

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Political Issues

Terrorism Canada has strongly supported US and international efforts to combat terrorism. Ottawa imposed economic sanctions on Libya in January and has firmly rejected suggestions to exchange trade delegations. After the revelations concerning the attempted bombing of the El Al flight, Ottawa also recalled its ambassador from Syria.

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Arms Control The Mulroney government is generally supportive of US arms control positions, but a vocal Canadian peace movement tempers Ottawa's public pronouncements on this issue. External Affairs Minister Clark has echoed the US assessment of the Reykjavik meeting, and Ottawa is standing by its agreement to permit US testing of cruise missiles over northern Canada. Ottawa has, however, frequently called on the US and the USSR to abide by the SALT agreements. On 28 November, Clark issued a statement deploring the US breakout from SALT II limits. Clark has tried to deflect opposition party calls to end cruise missile tests by portraying the program as a commitment to NATO, not a purely bilateral agreement.

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European Community

Political and Economic Setting

The European Community has been a back-bench participant at the annual Economic Summits since 1977 with all members represented by the Commission President and, in recent years, by the President of the Council of Ministers. We expect that EC Commission President Jacques Delors, a former French finance minister, will speak for EC interests in the areas over which the Community has direct competence: agriculture, trade, and to a lesser extent macroeconomic and monetary policy. Belgian Prime Minister Wilfred Martens, whose country will hold the rotating presidency of the Council of Ministers during the first half of 1987, is also expected to attend the Summit, but probably will be overshadowed by Delors. [REDACTED]

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Two central problems will be in the back of Delors' mind at Venice. The Community is beset with a chronic budget crisis, to a large extent the result of farm spending, that dominates its political agenda and divides the members along north-south lines. In addition, the effort to liberalize the internal EC market, after making some progress, is in danger of floundering. The US-EC trade dispute over Spanish grain imports will probably be solved by June, but, if not, will certainly surface in the bilateral talks at the Summit. [REDACTED]

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Economic Issues

Macroeconomic Policy Coordination Delors is likely to call for expansionary fiscal policies in Japan and in Europe. He probably believes West Germany, France, and the UK are in a good position to lower taxes, but will be careful not to single out West Germany as the "locomotive" because of strong German resistance to the idea. Delors also may argue--consistent with a recent Commission-prepared plan to boost growth in the EC--that government infrastructure spending and private investment must be expanded and that the growth in real wage costs must be slowed in order to reduce EC unemployment. [REDACTED]

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Structural Adjustment The top economic priority of the Community for the past eighteen months has been the completion by 1992 of the internal market--guaranteeing complete freedom of movement for goods, services, capital, and persons. The liberalization effort has experienced moderate success and is aimed at reducing bureaucratic interference in business decision making and giving EC firms the advantages of a more unified home market to help improve competitiveness. Delors is likely to promote the effort--fully supported by the member states, though they are failing to keep up with the decision making schedule because of disagreements over details--as the central element of the Community's attempts to assist restructuring of European economies. [REDACTED]

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Agricultural Reform The Commission and Delors are strong supporters of agricultural reform. Nevertheless, they are unable to accelerate reform proposals because of the requirement for unanimous agreement within the EC. Pressure for CAP reform is building, however, because of the EC's chronic budget crisis. The Commission estimates that farm spending could overrun the budget in 1987 by up to \$4 billion, sending the Community into a scramble for additional funds. CAP spending has generally been immune from budget cutbacks, but the severity of the crisis is likely to make CAP reform harder to resist next year. The EC is treating the issue of reform carefully in the new GATT round in order to avoid having the CAP singled out for discussion. []

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Delors believes that the United States and the EC should stop what he calls their "guerrilla war" over agricultural export subsidies. He probably feels that the major agricultural exporters must cooperate in solving the problem of overproduction and diminishing foreign markets. The Commission has long favored market-sharing arrangements between the major agricultural exporters, but because of known US antipathy to such agreements we do not believe Delors will make them a major issue. []

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Third World Debt The Commission has no real competence in the area of debt, but Delors is likely to argue that some improvements will result from maintaining enlarged LDC access to IMF resources, increasing World Bank lending, and implementing macroeconomic policies aimed at expanding developed country growth. []

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International Monetary Reform Delors' top priority in the monetary area is to ensure the stability of the European Monetary System (EMS). He will continue to advocate close and continuing cooperation to stabilize exchange rates, especially to preclude a further collapse of the dollar that could precipitate the need for a realignment of EMS currency rates. Delors may raise again the issue of Commission participation in Group of Seven discussions as part of his effort to increase the clout of the Commission in international monetary affairs. []

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International Trade One of the Commission's major goals will likely be to maintain pressure on Japan to take concrete measures to cut its trade surplus with the EC. This surplus is expected to increase by over 50 percent in 1986 to \$17 billion. Delors will probably argue for greater Japanese import promotion, export restraint, and a restructuring of the economy toward domestic-led growth. The EC also is challenging Japanese barriers to alcoholic beverage imports and the US-Japan semiconductor agreement in the GATT. []

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